Implementing the FASB's New Leasing Standard (ASC 842)

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

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Key Learning Objectives

- Lease Definition
- Separating Components of a Contract
- Lease Payments
- Lease Measurement
- Lease Classification and Expense Recognition

Key Learning Objectives

- Lease Remeasurement and Modifications
- Other Topics
- Lease Presentation and Disclosure Requirements
- Transition and Implementation Considerations

NOTE: We will be focusing on the LESSEE side today. However the new standard does have some changes for lessors.

Key Changes

Significant changes include:

- **New definition of a lease**
- **Operating leases on the balance sheet**
- **MORE judgement required!**
- Lease reassessment requirements
- Lease modification accounting
- **Disclosure requirements**

Scope exceptions

ASC 842 excludes leases of:

- Intangible assets
- Exploration for minerals, oil, natural gas, etc.
- Biological assets, including timber
- Inventory
- Assets under construction

Lease Definition

Lease Definition

A lease is a "contract", or part of a contract containing an "embedded lease" that:

- Conveys the right to control the use of…
- An identified piece of property, plant, or equipment (an "identified asset") for a period of time in exchange for consideration

Key Change: Under the legacy accounting guidance, a Company only had to determine whether it had the right to obtain substantially all of the economic benefit from the use of the asset.

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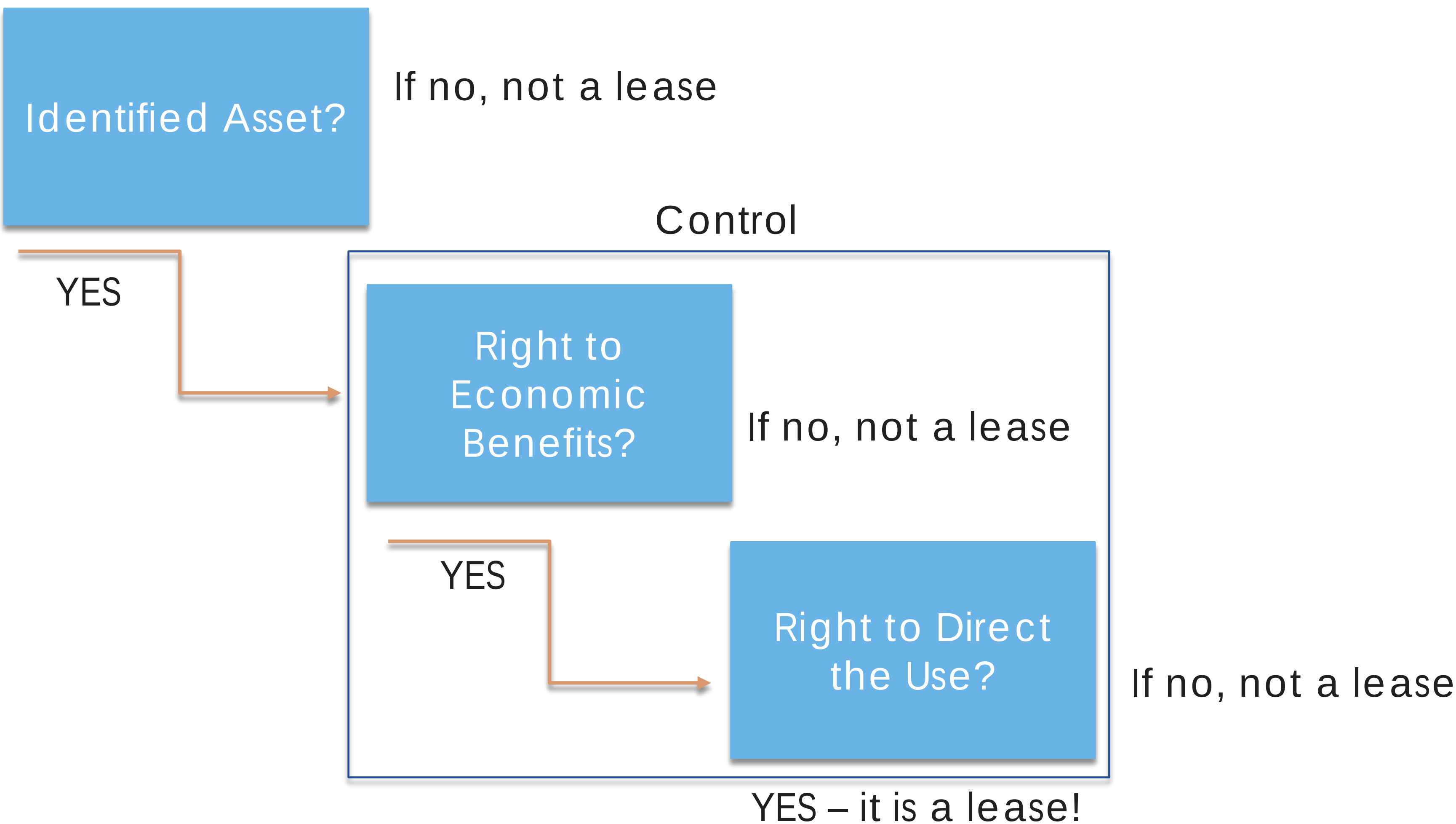
Definition of a Lease Overview



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Identified Asset

A leased asset must be identifiable either explicitly or implicitly (e.g. the only asset that can satisfy the contract)

- Substantive substitution rights can be a critical factor in determining whether an asset is identifiable
- A physically distinct portion of a larger asset could represent a specified asset
- A capacity portion of a larger asset will generally not represent a specified asset

Explicitly Identified Assets

If the supplier has a substantive substitution right, then the contract does not contain an explicitly identified asset

A lessor's right to substitute an asset is substantive only if both of the following apply:

- The lessor has the practical ability to substitute alternative assets throughout the period of use and
- Would benefit economically from the substitution

FASB has indicated that the presumption is that the right is not substantive unless there is direct evidence to the contrary.

Implicitly Identified Assets

An arrangement may implicitly identify an asset. This may occur if:

- Only one asset can be used to fulfill the contract or
- A contract permits substitution, but there are practical challenges to do so
  - **EXAMPLE:** If an asset is located at a customer's location, the cost to substitute the customer's asset is assumed higher than the cost to substitute an asset already on hand.

Implicitly Identified Asset – Data Center

Commercial bank enters into a data center contract. The supplier has multiple interchangeable data centers, but due to security measures, specific restrictions are imposed by the bank on the equipment.

Is there an implicitly identified asset?

Implicitly Identified Asset – Data Center (cont.)

Yes. Although the assets used to fulfill the contract are not explicitly specified, the assets are implicitly specified as a result of the contractual requirements and specifications mandated by Commercial Bank.

Control of Identified Asset

A customer controls an identified asset when the customer has both:

- The right to obtain substantially all of the economic benefits from its use, and
- The right to direct its use

Control of Identified Asset

The right to obtain substantially all of the economic benefits from its use

- Benefits that arise from use, not from ownership
- Consider only benefits that result from the defined scope of the customer’s right to use the asset in the contract

Control of Identified Asset

The right to direct its use

- Customer has the right to direct how and for what purpose the asset is used for the defined period

  OR

- The relevant decisions about how and for what purpose are predetermined and
  - The customer has the right to operate or to direct others to operate as it determines without the supplier having the right to change operating instructions

    OR

  - The customer designed the asset in a way that predetermines how and for what purpose the asset will be used

Control of Identified Asset

Decision making rights can indicate who has the right to direct the use of an asset:

- Right to change the type of output
- Right to change when output is produced
- Right to change where output is produced

Protective rights do not necessarily prevent a customer from having the right to direct the use

Rights limited to operating or maintaining the asset may not meet the above tests

Embedded Leases

Defined: Simply put, **embedded leases** are components within contracts that entail the use of a particular asset, where the user has control over that asset. You might be surprised at some of the types of contracts that often contain **embedded leases**, even though the contract may not contain the word "**lease**."

Embedded Leases (Continued)

Example: Equipment Use

- Within the scope of a contract, a construction firm may be utilizing construction equipment of another group/owner on site. This could be an embedded lease.

Need to assess contractual arrangements to see if any contain an embedded lease

- The decision may be different than the one reached under current GAAP

Embedded Leases (Continued)

Does customer have the right to substantially all of the economic benefits from the asset’s use?

Does customer have the right to direct how and for what purpose the asset is used?

- Right to operate the asset?
- Did the customer design the asset so as to pre-determine how and for what purpose it is used?

Identification of a Lease – Examples (Directly from the ASU)

Example 1A - Railcars

Contract provides use of 10 railcars for 5 years

- Railcars specified, owned by freight carrier (Supplier)
- Customer determines when, where, and what goods are to be transported (except for specified hazardous materials)
- Cars not in use kept at customer premises
- Supplier cannot retrieve cars except for repairs
- Supplier provides engines and drivers on request
- Lease?

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Example 1A - Railcars (Continued)

Yes – 10 identified cars

Restriction on cargo is protective. Restrictions on use define the right of use, but are not necessarily indicative of control

While engines and drivers are necessary, the supplier's decision making rights do not give it the ability to direct the use of the rail cars

Example 1B - Railcars

Supplier transports specified quantity of goods using specified type of cars for 5 years

- Supplier provides railcars, driver, and engine
- Customer determines when, where, and what good are to be transported
- Contract states nature/quantity of goods
- Supplier has large pool of cars that can be used
- Cars and engines stored at Supplier's premises
- Lease?

Example 1B – Railcars (Continued)

No

Pool of cars at supplier's location indicate that the supplier has the ability to substitute at little or no cost in a way that is economically beneficial

Warehouse Example

Warehousing Corp. owns a warehouse that can be subdivided. Manufacturing Corp. reserves 1,000 sq. ft. to store inventory for 3 years at a specified location. Warehousing Corp. can shift the inventory location at its discretion.

Is there an identified asset? Does the answer change if there is a specified temperature, and there is only one location with that temperature?

Warehouse Example (Continued)

No.

Not an identified asset.

Assume that 1,000 sf is only a small portion of a larger warehouse. Supplier can shift at its discretion.

Reasonable to assume that it would be economically beneficial for supplier to do so

However….. **If there are specifications, the answer may change.**

Separating Components of a Contract

Lease and Non-Lease Components

Contracts may contain both lease and non-lease components

- Lease component – the right to use the identified asset(s)
- Non-lease component – Involves the purchase of other goods or services (e.g. common area maintenance, parking, security)
- Executory costs (e.g. taxes and insurance) are not considered to be components, because they don't involve the delivery of a good or service

Key Concept: The lease liability is based on payments for lease components. Non-lease and executory costs are expensed as incurred.

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Allocation of Consideration

Consideration in the contract is allocated to lease and non-lease components on the basis of **"observable or estimable standalone prices"**

- Sound familiar?

Note that pricing breakdown in the contract may or may not be the same as standalone prices

Practical Expedient

Lessee may, as an accounting policy election by class of underlying asset, choose not to separate non-lease components and instead account for the arrangement as a single lease component

Key Concept: This will result in larger balance sheet impact. And a portion of the non-lease component payments will be included in interest. If you do not elect the practical expedient, non-lease components are all in operating expense.

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Lease Payments

Lease Payments

Lease payments included in measurement:

- Fixed payments
- In-substance fixed payments

Do not include:

- Variable payments based on usage or performance, or executory costs
- Amounts allocated to non-lease components

In-Substance Fixed Lease Payments

In-substance fixed lease payments appear to contain variability, but are unavoidable. For example:

- Variable payments depending on an index or rate (such as CPI or market interest rate)
- Variable payments subject to a minimum. The minimum is fixed. Any incremental payments are variable.
- The lower of the payments to be made when a lessee has a choice about which set of payments to make

Variable Costs

Lessee should recognize costs from variable lease payments when probable

Example

- Retailer pays variable rent as a percent of store sales

Key Takeaway: Do not have to project sales and usage to estimate future variable payments. Rather the expense is included as a component of rent expense when probable.

Example 12 A, B & C

5 year building lease, lessee pays for taxes and insurance

Lease is $10,000/year, plus taxes and insurance are variable

How are taxes and insurance accounted for?

What if lease cost was $13,000 (fixed), including taxes and insurance (itemized in contract)?

What if lease cost was $13,000 (fixed), including taxes, insurance and maintenance (itemized in contract)?

Lease Measurement

Measuring Lease Liability

The lease liability is measured as the present value of:

- Fixed payments for lease components, less lease incentives payable after commencement date
- Variable payments that depend on an index/rate
- Exercise price of reasonably certain purchase options
- Termination penalties if planning to exercise
- Amounts probable of being owed under residual value guarantees
- Structuring fees paid by lessee

Measuring Right of Use Asset

The initial right of use (ROU) asset consists of:

- The amount of the lease liability
- Plus: any lease payments made at or before commencement date
- Less: any lease incentives received at or prior to commencement date
- Plus: any initial direct costs

Key Takeaway: Lease incentive treatment varies depending on timing. This may mean the ROU will not equal the LL.

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Lease Term

Lease term includes:

- Non-cancellable term, beginning with commencement date
- Renewal periods if lessee has significant economic incentive to exercise option
  - **Example**: Significant leasehold improvements.
- Periods covered by an early termination option if lessee has a significant economic incentive not to exercise the termination option
- Periods where the exercise of those options is controlled by the lessor

Key Takeaway: The significant economic incentive is meant to be a high threshold. The default position is that the exercise of an option is not probable, unless there is specific evidence to the contrary.

What About Short Term Leases?

A lessee can elect an accounting policy not to recognize short-term leases on the balance sheet

- Election made by class of underlying asset
- Lease payments recognized on straight-line basis over lease term (like legacy GAAP)

Short term lease is one that, at the commencement date:

- Has a lease term of 12 months or less and
- Does not have an asset purchase option that the lessee is reasonably certain to exercise
- **Month to month leases at commencement are not included in this standard. However……**

Discount Rate

Discount rate:

- Based on information available as of lease commencement date
- Lessee should use lessor's implicit rate in the lease agreement
- If the implicit rate is not readily known, the lessee should use its incremental borrowing rate as of the lease commencement date

Discount Rate - Considerations

Lessor's implicit rate will likely be unknown

Incremental borrowing rate is the rate lessee would have to pay to borrow on a collateralized basis over a similar term for a similar amount in a similar economic environment

Private companies can take accounting policy election to use risk-free rate for period comparable to lease term

Is subsidiary able to borrow in their market without parent guarantee?

Portfolio Approach

Lease guidance can be applied at a portfolio level but only in situations where the lease applies to a group of homogenous assets that have identical or nearly identical lease terms

The application of the accounting model to the portfolio should not differ materially from the application of the model to the individual leases

Entity should apply judgement in selecting the size and composition of the portfolio

Key Takeaway: Consideration for fleets or copiers.

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Lease Classification and Expense Recognition

Lease Classification

Finance lease when any of the following are met at lease commencement:

- Ownership is transferred by the end of the lease term
- Lessee is expected to exercise purchase option
- The sum of i) PV of lease payments and ii) any guaranteed residual value approximate fair value of the asset
- Lease term is for major part of the remaining economic life of the asset

*The underlying asset is of such a specialized nature that it is expected to have no alternative use

Leases that do not meet any of the criteria would be classified as operating leases

Expense Recognition

Finance Lease

- Recognize interest expense separately as a finance cost, with the ROU asset amortized straight-line based on the lease term

Operating Lease

- Recognize lease expense on a straight line basis over the lease term, including interest. ROU amortization is a “plug”.

Classification Example #1

- 5 year lease of a standard forklift
- Annual lease payment: $10,000 in advance
- Useful life is 6 years
- Lessor's implicit rate is unknown; lessee's incremental borrowing rate is 5%
  - PV payments at 5% is $45,460
- The lessee estimates the FV of the forklift of $47,000
- No transfer of ownership or purchase option
- Finance or operating lease?

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Classification Example #2

5 year lease of a standard forklift

Annual lease payment: $10,000 in advance

Useful life is 10 years

Lessor's implicit rate is unknown; lessee's incremental borrowing rate is 5%

- PV payments at 5% is $45,460

The lessee estimates the FV of the forklift of $75,000

No transfer of ownership or purchase option

Finance or operating lease?

Journal entries on commencement date

- #1: Finance lease

ROU Asset	$45,460	
Lease Liability		$45,460
Lease Liability	$10,000	
Cash		$10,000

- #2: Operating lease

ROU Asset	$45,460	
Lease Liability		$45,460
Lease Liability	$10,000	
Cash		$10,000

- Entries are the same

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Lease Liability Amortization

	A	B	C	D	
			A-B	C*5%	C+D
Year	Beginning Lease Liability	Total Lease Payment	Balance After Payment	Interest for Year	Ending Lease Liability
1	$45,460	$10,000	$35,460	$1,773	$37,233
2	$37,232	$10,000	$27,232	$1,362	$28,594
3	$28,594	$10,000	$18,594	$929	$19,524
4	$19,524	$10,000	$9,524	$476	$10,000
5	$10,000	$10,000	$ -	$ -	$ -

- Liability amortization is the same for financing and operating leases

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Amortization of ROU Asset

- #1: Finance lease

Year	Beginning Balance	Annual Amortization	Ending Balance
1	$45,460	$9,092	$36,368
2	$36,368	$9,092	$27,276
3	$27,276	$9,092	$18,184
4	$18,184	$9,092	$9,092
5	$9,092	$9,092	$ -
		$45,460	

- #2: Operating lease

Year	Beginning Balance	Annual Amortization	Ending Balance
1	$45,460	$8,227	$37,233
2	$37,233	$8,638	$28,595
3	$28,595	$9,071	$19,524
4	$19,524	$9,524	$10,000
5	$10,000	$10,000	$ -
		$45,460	

- Finance lease ROU amortizes straight-line. Operating lease ROU amortizes so that total expense is straight-line.

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Total Expense by Year

- #1: Finance lease

Year	Interest Expense	Amortization Expense	Total Expense
1	$1,773	$9,092	$10,865
2	$1,362	$9,092	$10,454
3	$929	$9,092	$10,021
4	$476	$9,092	$9,568
5	$ -	$9,092	$9,092
	$4,540	$45,460	$50,000

- #2: Operating lease

Year	Interest Component	Amortization Component	Single Lease Expense
1	$1,773	$8,227	$10,000
2	$1,362	$8,638	$10,000
3	$929	$9,071	$10,000
4	$476	$9,524	$10,000
5	$ -	$10,000	$10,000
	$4,540	$45,460	$50,000

- Finance lease expense is accelerated . Operating lease expense is straight-line.

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Year 1 Expense Journal Entries

- #1: Finance lease

Interest Expense	$1,773	
Lease Liability		$1,773
Amortization Expense	$9,092	
ROU Asset		$9,092

- Total year 1 expense is $10,865.

- #2: Operating lease

Lease Expense	$10,000	
Lease Liability		$1,773
ROU Asset		$8,227

- Total year 1 expense is $10,000.
- Will be the same every year

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Accounting Summary

Example #1: Finance Lease

- Lease related expense are:
  - Interest expense, included with finance costs
  - ROU amortization expense, included in operating expenses
- Total expense declines each year
- Financing cash flows for principal portion; operating cash flows for interest portion

Example #2: Operating Lease

- All expenses are lease expenses included in operating expenses
- Total expense is the same each year
- All cash flows are operating cash flows

Lease Remeasurements and Modifications

Lease Remeasurements

Lessee remeasurements are required when:

- Lease is a modified, and modification is not accounted for as a separate contract
- A contingency is resolved, fixing previously variable payments
- Change in lease term
- Change in assessment of whether the lessee is reasonable certain to exercise a purchase option

Modifications

New specific guidance on accounting for lease modifications.

- Modification granting a new ROU asset at market rates is treated as a new lease
- Modifications changing the scope or resulting in a change in the total consideration trigger a remeasurement. Accounting depends on the type of change.

Remeasurement

When change in term or likelihood of exercise of purchase option trigger remeasurement, revalue ROU asset and lease liability updating all key inputs:

- Total consideration/ lease payments
- Allocation of consideration
- Discount rate
- Classification

Remeasurement

When facts and circumstances change concerning the resolution of a contingency or the amount owed on a residual value guarantee, revalue ROU asset and lease liability updating only:

- Total consideration/ lease payments
- Allocation of consideration

Other Sundry Topics

Other Sundry Topics

- Impairment
- Related-party leases
- Sale and leaseback transactions
- Build-to-suit transactions
- Leasehold improvements

Impairment

Regardless of classification, the ROU asset is tested for impairment consistently with other long-lived assets

If an operating lease is impaired, the lessee would amortize the remaining ROU asset evenly over the remaining lease term

- Continue to present the ROU asset amortization and interest components as a single expense item

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Related Party Leases

The recognition and measurement of related – party leases are based on their legally enforceable terms and conditions.

This is the case even when related-party transactions are not documented and/or the terms and conditions are not at arm's length. **This is common.**

Disclose lease transactions with related parties in accordance with the related party guidance in ASC 850

Sale and Leaseback Transactions

New model that applies to lessees and lessors

If the transaction is a sale, the seller-lessee recognizes the gain or loss immediately under ASC 606

If the transaction is not a sale, the seller-lessee accounts for the transaction as a borrowing

You may get a different answer than under legacy GAAP

Build to Suit Transactions

If lessee does not control the asset being constructed, any right of use payments made prior to lease commencement are prepaid assets

If lessee is deemed owner based on control (ASC 606 model), asset is capitalized as incomplete construction as costs are incurred

- Sale and leaseback accounting applies at commencement date

Leasehold Improvements

Similar to current U.S. GAAP, a lessee would capitalize a leasehold improvement as a separate asset and amortize it over the shorter of its useful life and the remaining lease term

However, a lessee would amortize a leasehold improvement over its useful life (even if such life is longer than the lease term) if:

- The lease transfers ownership to the lessee at the end of the lease term or
- It is reasonably certain that lessee will exercise an option to purchase the asset

Financial Statement Presentation

Statement of Financial Position

Finance and operating lease liabilities and ROU assets are presented separately from each other and from other liabilities and assets

- If the lessee does not present the above separately from other assets and liabilities, disclosure should state which line items include those ROU assets and liabilities
- Lease liabilities are classified as current/noncurrent

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Income Statement

Finance leases

- Interest expense reported in finance costs. ROU asset amortization is reported similarly to depreciation and amortization of similar assets
- Variable lease payments reported as lease expense

Operating leases

- Lease expense is included in income from continuing operations (including interest, ROU asset amortization, variable lease expense)

Statement of Cash Flows

Finance leases

- Principal payments classified as financing, while payments representing the interest component are classified as operating

Operating leases

- Lease payments are presented as cash flows from operating activities

Irrespective of classification, both variable lease payments that are not included in the lease liability and payments on short-term leases are presented as cash outflows from operating activities

Disclosure Requirements

Disclosures

Qualitative and quantitative information is required regarding an entity's leases, the significant judgements applied, and the related amounts recognized in the financial statements

Qualitative disclosures:

- Significant assumptions and judgements used
- Lease transactions with related parties
- Accounting policy regarding short-term leases
- Accounting policy elections for practical expedients
- Leases that have not yet commenced but give the lessee significant rights or impose significant obligations
- Information about the nature of leases and subleases
- Main terms and conditions of any sale-leaseback transactions

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Disclosure (Cont'd)

Quantitative disclosures (for each period presented):

- Finance lease cost (e.g., amortization of the ROU asset and interest on the lease liability)
- Operating lease costs
- Short-term lease costs (except for leases with a term of one month or less)
- Variable lease costs
- Sublease income, disclosed on a gross basis
- Gain or loss relating to sale-and-leaseback transactions

Disclosure (Cont'd)

Disclose the following amounts separately for its operating and finance leases:

- Undiscounted cash flows reconciled to amounts presented in the statement of financial position
- Cash paid for amounts included in its determination of lease liabilities (segregated between operating and financing cash flows)
- Supplemental noncash information on lease liabilities arising from obtaining ROU assets
- Weighted average remaining lease term and weighted average discount rate

Disclosure (Cont'd)

Good news?

- We have time to see what others are going to do.

Transition and Implementation Considerations

Transition practical expedients

Transition practical expedients for all leases expired or existing at the effective date (must be elected as a package of 3):

- An entity need not reassess:
  - Whether the contracts are or contain leases
  - The lease classification
  - Initial direct costs

An entity can separately elect the use of hindsight in determining the lease term, applied to all leases. Does not apply to changes in contract terms.

An optional transition approach can be chosen, whereby the ASC 842 guidance could be applied at the adoption date, without adjusting the comparative periods.

Transition Implementation Issues

Should the incremental borrowing rate be based on total payments and total lease term or remaining payments and lease term?

- Topic 842 is not clear. Either approach is acceptable, as long as it is consistently applied to all leases in transition and the policy is disclosed.

Transition Implementation Issues

What rate should be used in transition for leases with variable lease payments that depend on an index or rate?

- FASB position has been to use the index or rate at lease inception (unless the lease has been modified, in which case the index or rate at the modification date should be used).

SEC staff view (August 2018) is that lessees may use an index or rate for transitioning operating leases to ASC 842 that is consistent with the policy used currently for footnote disclosure

- A lessee may choose to change its current policy under the preferability guidance (ASC 250)

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Transition Accounting

Existing Operating Leases

- Recognize a ROU asset and lease liability at the later of (1) the earliest period presented or (2) the lease commencement date
- The lease liability is calculated as the PV of the sum of (1) the remaining minimum rental payments and (2) any probably amounts owed under a residual value guarantee
- The ROU asset should equal the lease liability, adjusted for prepaid rent, lease incentives, unamortized initial direct costs, any impairment

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Transition Accounting

Existing Capital Leases

- Reclassify existing capital lease assets as a ROU asset and the debt as a lease liability beginning with the earliest period presented
- Beginning with effective date, measure ROU asset and lease liability in accordance with subsequent measurement guidance of ASC 842

Build-to-suit Leases

- Determine whether or not lessee is owner and account accordingly

What Should Be Your Primary Concerns

Implementation questions:

- How do you capture a complete population of contracts for review?
- What information needs to be gathered for existing leases?
- How difficult will the data collection requirement be and what data elements need to be captured for each lease?
- Have you identified all embedded leases?
- How will you determine values of lease and non-lease components?
- Will you elect to use any of the practical expedients?
- What new accounting policies need to be established?
- What systems solutions are needed/available?
- What new disclosure controls and ICFR will be needed?

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Systems Challenges/Considerations

Capture of lease commencement date for transition reporting of index based agreements

Collection of disclosure requirements for transition reporting

Accounting for lease modifications and reassessments

Capture of variable lease cost

Calculation of weighted average discount rate and remaining lease term (especially with non-USD leases)

Linking of lease system to ERP

Calculation of foreign currency effects

Dual accounting for foreign entities that also reporting under IFRS

Implementation – What’s your Plan?

- First step in the Plan is to develop the Plan!!!
  - Who is responsible/involved?
    - Develop a timeline
  - Evaluation of leases/accounting
    - What is the impact?
  - Implementation Transition Method
  - Any changes needed to systems/close processes/internal controls?
  - Banks/Sureties (Discuss)
  - Other Stakeholders?

Implementation – What’s your Plan?

- In developing your plan, consider the following:
  - Additional time and cost required to implement the standard
  - Even if you believe that the new standard will have little or no impact, you need to support this assessment!
  - While the implementation date may be the last step in a plan, it may be the first decision to be made
    - Consider selecting an implementation date that is the same as the effective date and work backwards

Transition Timeline

All started with ASU 2016-2 – Leases in February 2016

- Multiple amendments all included in ASC 842

Effective date

- Public companies – FY beginning after 12/15/2018
- Private companies – FY beginning after 12/15/2019
  - FASB has proposed a one year delay – calendar year private companies would adopt 1/1/2021

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Final Q&A and Wrap-Up

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